technologically-neutral manner, as required by the Act. That way, the market, and not state or federal regulators, will determine who competes for and delivers services to rural consumers.

High-Cost Universal Service Mechanisms Are Enriching Rural ILECs at the Expense of Consumers.

There are numerous problems with the high-cost mechanisms, such as: (1) incentives for inefficiency; (2) funding of costs unrelated to universal service; and (3) impenetrable administrative complexity. Taken together, these problems result in a bloated fund that does not effectively target the appropriate levels of support to different high-cost areas. As a result, the high-cost support mechanisms do a poor job of ensuring that all Americans have access to high-quality, affordable telecommunications and information services. Moreover, the high-cost support mechanisms undermine the efficient development of competition as envisioned by the Act.

Incentives for Inefficiency. As the FCC correctly recognized in the *First Universal Service Order* in 1997, embedded cost-based high-cost universal service mechanisms reward inefficiency by creating incentives and opportunities for carriers to have higher embedded costs to receive more support. For example, between 2000 and 2003, the national average loop cost for rural incumbent LECs grew from approximately $337 per loop per month to approximately $378 per loop per month. This shows that, despite industry-wide efficiency gains, advances in technology, and amortization of depreciated equipment, high-cost universal service subsidies continue to increase rather than decrease over time.

In practice, the FCC's high-cost support mechanisms compound incentives for inefficiency inherent in embedded cost support mechanisms. For example, the high-cost

support mechanisms discourage carriers from taking advantage of economies of scale normally associated with combining operations. Under the high-cost loop support mechanism, smaller rural incumbent LECs are eligible for more high-cost loop support than larger carriers. In addition, the local switching support mechanism arbitrarily makes incumbent LECs with fewer than 50,000 access lines in a study area eligible for switching support. Incumbent LECs that increase their customer base risk reducing or eliminating their qualification for high-cost support. The embedded high-cost mechanisms' preference for small carriers also creates incentives for carriers to appear small when, in fact, they are much larger. Incumbent LECs do this by operating numerous "study areas" in a given state or by balkanizing their operations among the various states.

Guaranteed Profits and Reimbursement for Unrelated Expenses. As I noted at the outset, the FCC's high-cost universal service mechanisms are one of the few remnants of a pre-divestiture regulatory structure that guaranteed profits to inefficient monopolies insulated from competition. For example, the federal high-cost support mechanisms include a guaranteed rate of return of 11.25% for incumbent LECs. These elevated returns on equity do not translate to improved telecommunications services in high-cost areas. Instead, they simply enrich rural carriers and their investors, while increasing the overall size of the fund to the detriment of other carriers and consumers who end up paying higher universal service pass through charges.

In addition, rural incumbent LECs are permitted to recover Corporate Operations Expenses ("COE") through the high-cost loop support mechanism. These include everything from the salaries of rural ILEC executives, to their travel to conventions, to

lobbying fees. Such costs are not directly related to the provision of universal service, and should not be supported.

Impenetrable Administrative Complexity. The five separate high-cost support mechanisms, in conjunction with the waivers and other loopholes carriers use to enable themselves to receive additional high cost support, make the system an administrative and enforcement nightmare. Also, support calculations under the various federal high-cost support mechanisms rely on archaic and complicated cost accounting, jurisdictional separations, and reporting rules that have existed in one form or another since 1984.

The high-cost support mechanisms are so complicated that they have spawned a cottage industry of consultants who prepare and submit quarterly and annual cost reports on behalf of rural incumbent LECs. This administrative complexity also makes it exceedingly difficult for the Universal Service Administrative Company ("USAC"), the FCC's independent universal service fund administrator, to audit incumbent LEC cost data submitted for purposes of calculating high-cost support. This is compounded by rules requiring incumbent LEC cost data to be submitted to the National Exchange Carrier Association ("NECA"), not USAC. The FCC's rules provide for annual audits of USAC, not NECA. NECA has established its own cost reporting procedures outside FCC review, the Office of Management and Budget approval process, and most importantly, public scrutiny. NECA does not submit supporting documents for cost data to USAC. Rather, NECA processes such data and performs all support calculations prior to submitting them to USAC. Short of auditing NECA itself, there is no way for the FCC to know with certainty how NECA is interpreting and enforcing FCC cost reporting and

support calculation rules. These wasteful administrative costs are borne by consumers through higher rates for service, as well as higher universal service pass-through charges.

The Existing High-Cost Mechanisms Must Be Modified.

As I noted earlier, CTIA has developed both short-term and long-term proposals for improving the high-cost universal service support systems. The FCC and the Joint Board should modify the existing high-cost mechanisms, while transitioning to a new high-cost mechanism for all or some rural telephone companies. In the near term, only smaller incumbent LECs should continue qualifying for support based on embedded costs, and extraneous costs, such as risk-related profits and COE, should be removed from the support mechanisms. In the longer term, the five existing support mechanisms should be simplified and unified, and all incumbent LECs should be transitioned to a support mechanism based on forward-looking economic costs. These reforms will ensure that consumers in high-cost areas have better access to high-quality and affordable telecommunications and information services.

A Forward-Looking Support Mechanism Will Reward Efficiency and Reduce the Need For Support Over Time.

If properly designed, a forward-looking methodology for calculating high-cost universal service will do a far better job than an embedded cost system at directing appropriate levels of high-cost support to eligible carriers serving high-cost areas. Because a forward-looking mechanism provides an objective measure of efficient costs, it also will provide the appropriate incentives for investment, innovation, and entry into the marketplace. As the FCC observed in the *Universal Service First Report and Order*, in comparison to embedded cost support, "a forward-looking economic cost methodology creates the incentives for carriers to operate efficiently and does not give carriers any

incentives to inflate their costs or to refrain from efficient cost-cutting." Moreover, "in the long run, forward-looking economic cost best approximates the costs that would be incurred by an efficient carrier in the market."

A forward-looking mechanism such as that currently used for non-rural incumbent LECs also targets support to small geographic areas, thereby ensuring that "sufficient" support is available in high-cost areas. A forward-looking mechanism, therefore, will better ensure that consumers in high-cost areas have access to telecommunications services that are comparable to those available in urban areas, in terms of both rates and quality. Over time, a high-cost support system based on forward-looking costs also will reduce the need for support.

On several occasions, the FCC has rightly rejected arguments that the FCC indefinitely should maintain embedded cost support mechanisms for rural carriers. In the *Rural Task Force Order*, the FCC described numerous flaws with the Rural Task Force's conclusion that forward-looking support was not suitable for rural telephone companies. Indeed, the FCC concluded that all of the Rural Task Force's complaints about forward-looking support could be addressed by updating model inputs and using different benchmarks and averaging conventions.

The fact that some eligible carriers would receive less support under a new system is not a valid reason to reject reforms that would enable the FCC to better satisfy the requirements of the Act. The United States Court of Appeals for the Fifth Circuit previously agreed, stating that "[t]he Act does *not* guarantee all local telephone service providers a sufficient return on investment. . . . So long as there is sufficient and competitively-neutral funding to enable all customers to receive basic

telecommunications services, the FCC has satisfied the Act and is not further required to ensure sufficient funding of every local telephone provider as well." The FCC, therefore, must move forward with necessary reforms to the high-cost universal service mechanisms.

Now is the Time to Begin the High-Cost Reform Process.

On July 1, 2006, upon expiration of the five-year plan adopted in the *Rural Task Force Order,* incumbent LECs that, along with their affiliates, have 50,000 or more access lines in a state, or 2.5 million access lines nationally, should begin receiving support, if any, based on forward-looking economic costs. The Rural Task Force acknowledged that, with modest changes to the forward-looking mechanism, carriers with operations of this scope have no need to remain on an embedded-cost mechanism. Moving larger carriers to the model would affect a small percentage of rural incumbent LEC study areas, but would cover approximately 14 million or 65% of the total lines served by rural carriers.

"Rural telephone companies" in non-contiguous states and territories (*e.g.*, Alaska and Hawaii) and those that have fewer than 50,000 access lines in a state would remain under embedded cost support, but would be required to combine their study areas in any given state or territory.

The Joint Board and the FCC also should consider changes to the local switching support mechanism, which is premised on the idea that smaller carriers with less than 50,000 access lines in a study area have higher average switching costs. One idea would be to consider requiring incumbent LECs with fewer than 50,000 lines to prove that they in fact have higher average switching costs to continue receiving support. The Joint

Board and the Commission also could explore the possibility of reducing the threshold number of lines to reflect how economies of scale have changed over the last decade such that small carriers can now purchase cost-effective digital switches or even soft switches designed to meet their needs.

These changes would eliminate arbitrary distinctions made under the current mechanisms between "rural" and "non-rural" carriers. Instead, during an interim period, the rules would determine which carriers continue to receive embedded cost-based support solely based on the number of lines served.

At the same time, non-loop costs such as risk-related profits and COE should be removed from the high-cost loop support mechanism. The rate of return currently employed reflects the RBOCs' cost of capital 13 years ago; it also fails to recognize the lower degree of risk associated with a government-subsidized business. COE should be removed from the high-cost mechanism because, to encourage efficiency, companies should be required to recover these expenses from their own customers rather than subsidy mechanisms.

Finally, a freeze should be placed on further growth in the embedded cost support mechanisms while the Joint Board and the Commission consider long-term reforms. The local switching and interstate common line support funds would be frozen at current levels, and the overall size of the high-cost loop fund could go no higher than the funding year 2005 cap, based on 2003 cost data. Alternatively, growth in these funds could be tied to industry revenue growth (or reductions), as was proposed by the Oregon Public Utility Commission in the Competitive Eligible Telecommunications Carrier proceeding.

More Fundamental Reforms Are Necessary in the Long Term

The reforms I just outlined will be merely first steps towards the long-term goal of transitioning all carriers to a single, unified federal support mechanism based on forward-looking economic costs. A single forward-looking mechanism will reduce unnecessary costs and burdens associated with managing multiple mechanisms. A high-cost support mechanism based on a forward-looking cost model also would eliminate the current need for detailed cost reporting. In contrast to the multiple cost elements requirement under Part 36 of the FCC's rules, a forward-looking mechanism would only require carriers to report wire center line counts on a quarterly basis, and wire centers locations and customer locations less frequently. These filings could be further reduced if USAC were to obtain the customer location data from an independent vendor.

The FCC also should eliminate unnecessary and costly administrative layers by centralizing administration of the high-cost support mechanisms in USAC. For high-cost universal service support, this would, for example, mean that USAC should replace NECA as the recipient of all necessary data for calculation of high-cost support. USAC also should take over responsibility from FCC staff for managing the day-to-day operations of the forward-looking model. USAC is better suited to perform these administrative functions than the FCC. This would aid in the administration and enforcement of the mechanisms.

The FCC first should transition all incumbent LECs to a unified forward-looking high-cost mechanism that would replace the existing high-cost loop support, local switching support, and (the current) forward-looking mechanism. Significant work would need to be done to prepare and modify the model to accommodate smaller carriers.

Under the current forward-looking high-cost support mechanism, support is only available to 10 states due to the operation of the benchmark and statewide averaging. In order to ensure that support is more widely available, while maintaining or reducing the overall high-cost fund size, the FCC could eliminate statewide averaging and increase the benchmark from two standard deviations above the national average to a higher number. The FCC should make sure the benchmarks chosen do not result in an increase to the overall size of the high-cost support mechanisms.

The next step would be for the FCC to eliminate arbitrary interstate and intrastate cost separations and fold interstate common line support and interstate access support into the unified forward-looking high-cost support mechanism. The high-cost universal service support mechanisms should be agnostic to interstate and intrastate distinctions, which are becoming increasingly irrelevant. Moreover, since the federal universal service mechanisms already subsidize both intrastate and interstate costs, nothing precludes the FCC from combining these separate mechanisms. This step would significantly simplify support calculations.

Any incumbent LEC USF revenue losses resulting from the transition to forward-looking support should only be recovered through end-user charges (*e.g.*, SLC and other end-user charges), not through access and other carrier charges (which would result in illegal implicit subsidies). If an eligible carrier is thereby forced to increase its end user rates to "unaffordable" levels (*i.e.*, rates that are not comparable to those charged in urban areas), it would have the option of petitioning the FCC for additional high-cost universal service support. To the extent that a carrier is able to charge close to or, in some cases,

less than an "affordable" rate for service, there is no justification or basis in the Act for requiring other carriers and customers to subsidize that service.

In order to ensure that high-cost support mechanisms decrease, rather than increase, over time, the Joint Board should recommend that the FCC amend its rules to require regular (*i.e.*, annual or biennial) updates to the forward-looking mechanism to reflect the introduction of more efficient technologies. This will be extremely important over the next several years as circuit-switched networks are replaced with packet-based technology. The Joint Board and the FCC also could consider reducing support over time for both the incumbent and competitors in those markets where consumers have multiple facilities-based competitive alternatives.

Once these steps have been taken, the Commission should consider additional reforms that would better serve the underlying statutory goals for universal service. For example, the Joint Board and the FCC could consider developing a high-cost mechanism that directs equal per-line support to both incumbent and competitive ETCs based on the most efficient technology in a selected area. Such a mechanism could determine whether universal service is best achieved in an area using wireline packet or circuit-switched technology, or wireless technology.

In the very long term, the Joint Board and the Commission should continue to study the possibility of abandoning cost-based support altogether in favor of a system of competitive bidding that would determine high-cost support levels for both competitors and incumbents. Another creative idea would be to investigate the feasibility of directing a consumer subsidy based on a combination of the cost of service and the consumer's income, thereby merging the high-cost and low-income support mechanisms.

The FCC Must Reject Proposals to Discriminate Against Wireless Carriers.

Whatever steps the FCC takes to reform the high-cost support mechanisms, the Act demands that such support must be available on a technologically- and competitively-neutral basis. The Joint Board therefore should reject proposals to give the incumbent and competitive ETCs in a particular market unequal per-line support amounts. Specifically, the Joint Board should reject blatantly discriminatory proposals to give competitive ETCs support based on their own embedded or forward-looking costs when those costs are less than the incumbent carrier's costs (but not when competitive ETC costs are the same or more than the incumbent's costs). Instituting a system that always gives competitive ETCs the short end of the universal service stick will significantly handicap competitive ETCs in the competitive marketplace – in some cases, literally requiring a wireless carrier to be two to three times more efficient than the wireline incumbent when competing for the same customer.

Wireless deployment in rural areas has occurred, in part, because of competitively neutral access to high-cost and low-income universal service support. Deployment of wireless services in rural markets is more costly on a per-customer basis than serving a more densely populated area. As with wireline networks, factors such as lower population densities, topography, and geographic isolation make the average cost of providing mobile wireless services in rural areas significantly higher than in urban areas. Western Wireless, for example, is reported to be spending five times as much capital and is building nine times as many cell sites in North and South Dakota, where it has been designated an ETC, than in Montana, where it has not been designated.

In some cases, wireless ETCs have brought universal service to rural and insular areas that traditionally have been underserved or unserved by incumbent LECs. The FCC has recognized, for example, that certain regions of the country, such as Appalachia, the Mississippi Delta, and Tribal Areas, have lower telephone penetration rates than other regions in the country and that the wireless industry can be a key player in deploying services to these areas.

The goal of competitive neutrality in the distribution of universal service funds is not just a worthwhile policy goal. It is required by statute. The FCC recognized this statutory mandate in its *First Report and Order* on universal service, stating that the universal service mechanisms rules should neither unfairly advantage nor disadvantage one provider or technology over another.

The courts also have ruled in support of nondiscrimination in the universal service context. In *Alenco Communications, Inc. v. FCC*, the United States Court of Appeals for the Fifth Circuit stated that the universal service program must treat all market participants equally (by making subsidies portable) so that the market, and not local or federal regulators, determines who competes for and delivers services to customers.

Conclusion.

Almost nine years after passage of the Telecommunications Act, it is time for the Joint Board and the FCC to complete necessary reforms to the high-cost universal service support mechanisms to make them more consistent with the Act's universal service and pro-competition goals, while curbing growth in the fund. To achieve the goals of universal service, the FCC should develop a simplified, unified, forward-looking high-cost support mechanism that replaces the five existing high-cost support mechanisms.

Whatever changes are made to the high-cost mechanisms, the Joint Board and the FCC must ensure that universal service support continues to be distributed in both a competitively and technologically neutral manner, as required by the Act. These steps will ensure that consumers, the intended beneficiaries of universal service, have more uniform access to high-quality and affordable telecommunications and information services, as the statute requires.

Thank you for your time and attention.

Jeffrey Reynolds
Parrish, Blessing & Associates

Jeff Reynolds is a principal in the economic consulting firm of Parrish, Blessing & Associates ("PBA"). Prior to joining PBA in 2001, Jeff was Vice President – Wholesale Services for ALLTEL Corporation in Little Rock, AR. He has held a number of executive and management positions within the telecommunications industry beginning as a traffic engineer for North Pittsburgh Telephone Company in 1974. He received his B.A. degree from Case Western Reserve in Biology, Mathematics and Statistics.

Jeff has been active in telecommunications policy development and has worked for or with midsize rural telephone companies throughout his career. He has been a member of many industry committees and is a former chairman of USTA's Regulatory Issues and Advocacy Committee (now Regulatory Tactics). He is a former NECA Subset 2 Board member.

Jeff resides in North Little Rock, Arkansas with his wife, Gayle and daughter, Erin.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
	)	

Prepared Testimony of Jeffrey Reynolds on Behalf of Independent Telephone & Telecommunications Alliance Before the Federal-State Board on Universal Service

I. Introduction and Summary

My name is Jeffrey Reynolds. I am a principal in the economic consulting firm of Parrish, Blessing & Associates, Inc. ("PBA"). PBA provides economic, financial and regulatory consulting services primarily to midsize ILECs - many of our clients are Independent Telephone & Telecommunication Alliance ("ITTA") members. Prior to joining PBA in 2001 I was employed by ALLTEL Corporation as Vice President – Wholesale Services at its headquarters in Little Rock, Arkansas. Throughout my thirty-year telecommunications career, I have worked for or with midsize ILECs, beginning with my employment with North Pittsburgh Telephone in Gibsonia, Pennsylvania in 1974.

I am testifying on behalf of the ITTA, an organization of midsize ILECs that collectively operate in more than 40 states, and provide local exchange and exchange access service to over ten million access lines. ITTA's member companies offer a broad range of services to their customers, including interexchange, Internet, broadband, video and wireless. Most ITTA member companies qualify as rural telephone companies within the meaning of Section 3(37) of the Communications Act of 1934, as amended (the "Act").[1]

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[1] 47 U.S.C. § 153(37).

ITTA appreciates the opportunity to offer this testimony on the continuing need to provide "specific, predictable and sufficient" universal service high-cost support for rural carriers. By this testimony, ITTA urges the Joint Board to recommend that the FCC retain the definition of "rural" used to qualify for high-cost support[2] and to continue to calculate support on a study area basis. In the collective experience of ITTA members the current mechanism for determining and distributing high-cost support to rural carriers is functioning well. There is no compelling justification for the Joint Board to abandon the use of the statutory definition of "rural telephone company" as the threshold for determining eligibility for rural high-cost support. Changing eligibility criteria for universal service high-cost support – by, for example, requiring carriers to calculate average cost-per-line at a level larger than the study area level – likely would strip many rural communities of their support based simply on the fact that they are served by a carrier that is part of a larger holding company structure. Such a change would lead to impermissible implicit subsidies and would render service unaffordable in many rural areas, in violation of Sections 254(b)(3) and 254(e) of the Act.

ITTA also requests that the Joint Board recommend retaining use of embedded actual costs in calculating support levels for a given rural study area. The current system utilizing embedded costs best meets the "specific, predictable and sufficient" tenets for universal service explicit in the act. By their very nature actual costs are the most precise measure for determining support for rural ILECs. Any other approach would create serious dislocations in funding and jeopardize the goals of universal service.

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[2] SureWest Communications, an ITTA member company, believes the present definition for rural treatment of high cost companies is flawed.

II. The Unique and Variable Nature of Rural Markets Justifies the Continued Use of the Term "Rural Telephone Company," as Defined in the Act, to Determine Eligibility for High-Cost Support in Rural Areas

Currently, to determine which carriers serve are eligible for high-cost support in rural areas, the FCC uses the statutory definition of "rural telephone company."[3] This multi-part definition has worked well over the last eight years to properly target high-cost support to rural communities, the characteristics of which are highly variable, but which have many aspects in common. The Joint Board should not adopt proposals to modify the eligibility criteria for rural universal service support.

Section 254(b) of the Act sets forth the principles that govern federal universal service policies. Specifically, Section 254(b) requires that support mechanisms be specific, predictable, and sufficient to preserve and advance universal service.[4] In addition, federal universal service policies must ensure that consumers in rural, insular, and high-cost areas have access to telecommunications and information services that are reasonably comparable to those services provided in urban areas, and at reasonably comparable rates.[5] FCC precedent demonstrates that the characteristics of rural areas justify treating them differently from non-rural areas.

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3 *Universal Service First Report and Order*, 12 FCC Rcd at 8943-44, ¶ 310. Specifically, Section 153(37) provides that:

> The term "rural telephone company" means a local exchange carrier operating entity to the extent that such entity – (A) provides common carrier service to any local exchange carrier study area that does not include either – (i) any incorporated place of 10,000 inhabitants or more, or any part thereof, based on the most recently available population statistics of the Bureau of the Census; or (ii) any territory, incorporated or unincorporated, included in an urbanized area, as defined by the Bureau of the Census as of August 10, 1993; (B) provides telephone exchange service, including exchange access, to fewer than 50,000 access lines; (C) provides telephone exchange service to any local exchange carrier study area with fewer than 100,000 access lines; or (D) has less than 15 percent of its access lines in communities of more than 50,000 on the date of enactment of the Telecommunications Act of 1996.

47 U.S.C. § 153(37).

4 47 U.S.C. §254(b)(5).

5 *Id.* § 254(b)(3).

A one-size-fits-all approach to the universal service fund simply will not capture the uniqueness and variability of rural markets as Congress intended. Record evidence abounds demonstrating the unique attributes of rural markets, as well as the diversity among rural markets.[6] Compared to the larger ILECs, rural carriers generally serve smaller subscriber bases which are comprised of people who live in more sparsely populated areas.[7] Rural carriers serve fewer than twelve percent of the nation's access lines in total,[8] but 38% of the nation's land area, and 93% of the study areas.[9] While the average population density for areas served by non-rural carriers was 105 people per square mile, the average population density for areas served by rural carriers is merely 13 people per square mile.[10]

Not only do the markets served by rural carriers differ significantly from non-rural markets, but wide variability exists *among* rural markets as well. The many differences even among the areas that currently receive "rural" treatment under the Act confirms that there is *no* single test (such as companies with fewer than 100,000 lines) that would accurately capture all companies that merit categorization as "rural." The number of lines served by individual rural carriers varies, and the range of their costs varies greatly. For example, among ITTA members, ALLTEL's smallest study area, ALLTEL New York – Red Jacket, has fewer than 2,800 lines, while CenturyTel's study areas range in size from tiny CenturyTel of Chester, Iowa, with 221 lines, up to CenturyTel of Washington, with approximately 180,000 lines. TDS's study

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6 *See, e.g.*, Rural Task Force, *The Rural Difference*, White Paper #2 (Jan. 2000) ("*Rural Task Force White Paper #2*") at 50.

7 *In the Matter of Federal-State Joint Board on Universal Service*, Recommended Decision, FCC 00J-4, 16 FCC Rcd 6153 (rel. Dec. 22, 2000) ("*Rural Task Force Recommendation*") at A-11.

8 *In the Matter of Federal-State Joint Board on Universal Service*, Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order, 18 FCC Rcd 22559, 22559 n.1 (2003) ("*Non-Rural High Cost Modification Order*").

9 *Rural Task Force Recommendation*, 16 FCC Rcd at A-11.

10 *Id.*

areas range from just over 100 lines (Asotin Telephone Company, Oregon) to approximately 64,000 (Tennessee Telephone Company).[11] With respect to investment-related costs, wide variability exists as well. The gross investment in central office switching equipment ranges from very small amounts to as much as $9,191 per loop.[12] Loop costs also vary widely among rural carriers, with the range in expense per loop spanning between $4 and $1,585.[13] Use of the definition of "rural telephone company" under the Act captures the variability of these markets better than any single test could.

As a result of the factors described above, rural carriers require substantially more telecommunications plant to reach customers in high-cost areas than metropolitan carriers require. At the same time, average disposable income levels in rural communities are lower than in urban communities. Further accentuating the differences between rural and urban areas, in recent years, rural incomes also have not kept pace with incomes in urban areas. Thus, increases in local rates are more likely to adversely impact customers in rural areas than in urban areas.

As discussed further below, many proposals currently being considered by the Joint Board would result in many carriers and the communities they serve losing their eligibility for rural high-cost support. Considering the comprehensive reforms currently under consideration at the FCC, it is dangerous to make radical changes in the universal service rural support eligibility rules at this time. Among other things, the FCC is considering major changes to the current system of intercarrier compensation and access revenues as well as the designation of competitive eligible telecommunications carriers ("CETCs"). Any change to the rural

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11 *See* Universal Service Administrative Company, High Cost Loop Support Projected by State by Study Area, 2Q 2004, available at http://www.universalservice.org/overview/filings (last visited Oct. 4, 2004). *See also* Monitoring Report, CC Docket No. 98-202, (rel. Oct. 2001) at Table 3.27 (all statistics).

12 *Rural Task Force White Paper #2* at 50.

13 *Id.* at 54.

universal service fund eligibility rules or calculation of support that do not account for the massive reforms also under consideration at the FCC could have a devastating effect on rural communities. The Joint Board should make its recommendations to the FCC with the unique characteristics of rural areas in mind, and should not exacerbate the precarious regulatory environment already faced by rural carriers.

III. Rural Telephone Companies Should Continue to Receive Cost-Based Support at the Study Area Level

The Joint Board should reject proposals to penalize operating companies that are owned as part of a larger holding company structure by calculating a carrier's costs across an entire holding company or at a state-wide level. By averaging costs across an entire state or holding company, many rural areas would no longer be considered "high-cost" thus depriving numerous rural communities of universal service funding. The study area remains the proper level for calculating support.

Holding companies maintain multiple study areas within a given state for a variety of reasons. It is important to understand that ILEC study area boundaries were and are not chosen by the ILEC, but rather were fixed by the FCC in 1984 to guard against ILECs establishing high cost exchanges within existing study areas in order to maximize support. ITTA's members that operate multiple study areas within a particular state have grown largely as a result of merger and acquisition activity. In many cases the rural holding companies have acquired study areas and/or exchanges from non-rural ILECs selling off more rural high cost properties. The costs and operational characteristics of the acquired study areas often are different from those of pre-existing study areas. Local rates and intrastate access rates typically are required to be maintained at pre-acquisition levels. The Notice failed to address the interaction between study area consolidation and these and other state and federal policies.

Retaining existing study areas within a state following a merger or acquisition maintains the structure upon which the viability of the transaction was evaluated. Thus, there are no distortions resulting from the retention of separate study areas.

In contrast, adoption of a requirement to average costs across a company's study areas state-wide or holding company-wide would create pricing distortions in local rates. Any "averaging" approach to a cost recovery mechanism invariably creates implicit subsidies. Loss of support to rural areas would require carriers to raise rates in lower cost markets to subsidize rates in high-cost areas. This is in direct conflict with Section 245(e), which requires that support be explicit. The creation of implicit support also is not sustainable in a competitive market. Today, even rural carriers face substantial competition from a variety of providers. Carriers cannot afford to raise rates in relatively low-cost areas because of competitive pressures. The only practical option would be to raise rates to customers only in the highest-cost markets. As stated above, such cost increases could cause even basic services in those areas to become unaffordable, which clearly violates the universal service mandates of the Act.[14]

Further, adoption of any proposal to require aggregation of study areas within a state or to aggregate all study areas served by companies owned by a common holding company could create insurmountable challenges for numerous rural communities. The midsize companies alone stand to lose tens of millions of dollars in federal high-cost support each year if this proposal were to be adopted. Holding companies that, through their operating subsidiaries, serve both rural and urban areas would be encouraged to sell off urban exchanges to avoid a scenario where costs averaged across a study area would cause the holding company to be ineligible for support. The Joint Board should not recommend any proposal that would

[14] 47 U.S.C. § 254(b)(3).

encourage wholesale changes to corporate structures in order to minimize loss of universal service support. Such fractionalization of the industry would destroy economies of scale that cannot be matched by independent ILECs.

The current system fully captures the efficiencies of holding companies, by reducing their per-line support amounts across each study area and across multiple study areas. The existing methodology accurately captures each operating company's allowed costs, while limiting recovery of corporate overheads. Also limiting cost recovery, rural ILEC high-cost loop support is capped.[15] Moreover, the efficiencies achieved by holding companies are fully reflected in rural carriers' costs as reported for universal service purposes and drive down demands on the fund. In contrast, a system that encourages divestitures of lines to smaller companies would create new inefficiencies, driving up demand on the high-cost fund.

Aggregating costs statewide (or even nationwide) harms rural consumers, establishes inefficient, implicit subsidies and would fail to provide "specific" (targeted) support. The study area is the level at which costs are currently measured and cost/price distortions are minimized. Aggregating costs at a level higher than study area is not in the best interests of rural customers who depend on the support for access to a network of advanced telecommunications services. By contrast there is no benefit to establishing a high-cost universal service mechanism on a more granular level such as wire center. Embedded costs are not measured at the wire center level and imposing the administrative requirements associated with maintaining costs at this level would not increase the specificity or the precision of the support calculation. There is

[15] 47 C.F.R. §36.601(c).

currently an optional mechanism in place that allows a rural study area to disaggregate high-cost support should it prove necessary.[16]

IV. Adopting a Forward-Looking Cost Model Would Cause Significant Disruption In Rural Markets, With No Guarantee of Public Benefit

The current system of calculating rural high-cost universal service support was designed to ensure that support is tailored to the specific needs of the carrier-of-last-resort. Calculating rural universal service using actual embedded cost produces funding that is predictable and sufficient (or would be sufficient if not for the caps imposed by the FCC in recent years). The differences between rural and non-rural carriers make it problematic to apply the forward-looking high-cost support mechanism adopted for non-rural carriers to rural carriers.[17] The FCC has concluded in the past that the universal service support mechanisms for rural carriers should differ from those for non-rural carriers at least on an interim basis.[18] Citing the many differences between rural and non-rural carriers, the FCC *twice* has declined to adopt a forward-looking economic cost model for rural carriers.[19] The Joint Board should recommend that the FCC once again reject a movement away from embedded costs.[20]

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16 *See* Comments of the Independent Telephone and Telecommunications Alliance, CC Docket No. 9645, FCC 04J-2, at 21 (filed Oct. 15, 2004).

17 *See Federal-State Joint Board on Universal Service Seeks Comment on Certain of the Commission's Rules Relating to High-Cost Universal Service Support*, Public Notice in CC Docket 96-45, FCC 04J-2, at ¶¶ 28-32 (rel. Aug. 16, 2004) ("Public Notice") (seeking comment on the application of the synthesis model to rural carriers).

18 *Universal Service First Report and Order*, 12 FCC Rcd at 8934 (¶ 291).

19 *Id.*; *In the Matter of Federal-State Joint Board on Universal Service, Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, Fourteenth Report and Order, Twenty-Second Order on Reconsideration, and Further Notice of Proposed Rulemaking in CC Docket No. 96-45, and Report and Order in CC Docket No. 00-256, 16 FCC Rcd 11244, 11256 ¶25 (2001) ("*RTF Order*"), as corrected by *Errata*, CC Docket Nos. 96-45, 00-256 (Acc. Pol. Div. rel. Jun. 1, 2001), *recon. pending.*

20 *See* Comments of the Regulatory Commission of Alaska, CC Docket No. 9645, FCC 04J-2, at 6-7 (filed Oct. 15, 2004) (demonstrating that a forward-looking cost model is inappropriate for rural areas).

Utilizing an embedded cost mechanism to determine universal service support is the most precise method for determining network cost recovery. Such a system depends on measurable, historic costs of a network that is in place and functioning, and provides a reliable account of the actual cost of deploying and operating rural networks.[21] It is a self-correcting mechanism in that cost changes are accounted for in the calculation of universal service support. Efficiencies resulting from economies of scale and scope, changes in technology and other operational economies are reflected in the calculation and result in a reduced cost per line and a correspondingly lessened dependency on high-cost support. Basing the calculation on actual costs also eliminates any potential for "gaming" of the high-cost universal service support system by over-estimating or under-estimating costs. A rural ILEC that under-invests in the network realizes a reduction in its support payments in direct relation to its reduced spending.

ITTA has good reason to be pessimistic about basing cost recovery on forward-looking costs. Establishing a methodology predicated on forward-looking costs is a task that has proven to be unwieldy, inaccurate and an enormous drain on FCC and state commission resources. The use of forward-looking proxy costs has been plagued by a lack of precision. Even after spending more than two years in developing a non-rural proxy model for the calculation of high cost universal service funding (the FCC's Hybrid Cost Proxy Model or Synthesis Model), the FCC did not believe that the model predicted loop costs in a specific and precise fashion. Instead the FCC used the costs produced by the Synthesis Model in a relative

[21] *See* Comments of the National Exchange Carrier Association, CC Docket No. 9645, FCC 04J-2, at 13 (filed Oct. 15, 2004).

fashion to distribute funds among states qualifying for non-rural high-cost universal service funds.[22]

While the task of developing a forward-looking cost proxy model has proven to be difficult with non-rural companies that are relatively homogenous, the task would be exponentially more difficult when attempting to model the costs of a population of widely variant rural carriers. In evaluating proxy models for use in calculating high-cost support for rural carriers, the RTF concluded in its White Paper #4[23] that because of the variability in results, adoption of a proxy model for determining rural high cost support would produce extremely large dislocations (including reductions as well as potential windfalls) in universal service support for rural customers. For this reason the RTF recommended a continued reliance on an embedded cost methodology. There has been no material change in circumstance since then to warrant adoption of proxies.

The Total Element Long Run Incremental Cost ("TELRIC") forward-looking cost model for unbundled network elements ("UNEs") has produced notoriously wide-ranging results, leading to a tortuous succession of workshops, hearings, briefings and arbitrations at the federal level and in states throughout the country. The Regulatory Commission of Alaska, which has significant experience with both rural carriers and forward-looking cost models, supports keeping rural companies on an embedded cost basis because a forward-looking model would not accurately predict costs in rural Alaska. Indeed, even in the non-rural city of Anchorage,

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[22] *See generally Application by Verizon New England Inc., Verizon Delaware Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance, NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization to Provide In-Region, InterLATA Services in New Hampshire and Delaware*, 17 FCC Rcd 18660, 18689 (¶¶ 47-48) (2002) (explaining that the Commission developed an extensive record to support its conclusion that the Synthesis Model accurately reflects relative cost differences between states).

[23] *See generally* Rural Task Force, *A Review of the FCC's Non-Rural Universal Service Fund Method and the Synthesis Model for Rural Telephone Companies*, White Paper #4 (Sept. 2000) ("*Rural Task Force White Paper #4*").

depending on the "interpretation" of TELRIC, the predictable cost of a loop in ACS' Anchorage market has varied from $5 to $25.[24] It strains credulity that the Joint Board would even consider inflicting this forward-looking cost model morass on rural carriers, considering TELRIC's dubious track record. The Joint Board should therefore recommend that the FCC continue to calculate costs on a rural carrier's embedded costs, rather than developing a forward-looking cost model for rural universal service.

[24] *See* Comments of ACS of Alaska, Inc., ACS of Fairbanks, Inc., ACS of the Northland, Inc. and ACS of Anchorage, Inc., CC Docket No. 9645, FCC 04J-2, at 12 (filed Oct. 15, 2004).

V. Conclusion

ITTA urges the Joint Board to move cautiously when recommending changes to the current universal service support mechanism for rural carriers. The current rural high-cost support mechanism is not "broken." The statutory definition of "rural telephone company" properly identifies those carriers eligible for rural universal service support. Similarly, there is no need to "average" costs at the state or national level – funding requirements do not vary as a function of corporate parentage. Further, there is no evidence that a forward-looking cost approach would be appropriate for or ultimately effective in for determining rural high cost support. Actual embedded costs continue to be the proper method for establishing universal service support that is "specific, predictable and sufficient" and ensures continued access to advanced services through a modern telephone network for customers in rural markets.

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/s/

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